

# **Tax News**

## **February 2008**

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## SB 1055 seeks to alleviate potential tax on mortgage foreclosures

### Would conform California to key parts of the federal mortgage forgiveness debt relief law

As the mortgage foreclosure crisis deepens, actions at the state and national level aim to offer some relief to affected homeowners. On December 20, 2007, President Bush signed the federal Mortgage Forgiveness Debt Relief Act of 2007. Among other things (see below: “Other provisions of the federal legislation”), this law removes the potential tax liability on indebtedness (i.e. a principal residence mortgage) that is forgiven or discharged by the lender, up to a maximum of \$2 million for married filing joint taxpayers, and \$1 million for single filers. To be considered a principal residence, the owner must have lived in the home for any two of the past five years.

In California, proposed legislation would provide conformity with the federal Mortgage Forgiveness Debt Relief Act of 2007, target abusive mortgage lending practices, and provide aid for struggling homeowners. On January 7, 2008, California Senator Mike Machado announced Senate Bill (SB) 1055 (co-authored by Senators Michael Machado, Linden; and Lou Correa, Santa Ana). SB 1055 addresses tax relief by excluding forgiven mortgage debt from income for state income tax purposes (see related article in our October 2007 issue: Foreclosures and the next wave). Like the federal law, SB 1055 would take effect immediately.

If it passes, SB 1055 will conform to specified provisions of the federal Mortgage Forgiveness Debt Relief Act of 2007 – with a notable difference. For California taxpayers, the period of excludable discharges would be from January 1, 2007, to December 31, 2008. The federal period of excludable discharges is from January 1, 2007, to December 31, 2009.

### Other provisions of the federal legislation

Although most attention is focused on removing the potential tax liability of principal residence debt that is forgiven by the lender, the federal Mortgage Forgiveness Debt Relief Act of 2007 contains additional provisions.<sup>1</sup> These additional provisions were not included in SB 1055, thus California would **not** conform. Briefly, these include:

- Extending the tax deduction for mortgage insurance premiums through 2010.
- Establishing two new alternative tests for cooperative housing corporations’ qualification to deduct tax payments paid to the co-op housing corporation:
  1. Eighty percent or more of the total square footage of the corporation’s property is available for residential use by tenant-stockholders.
  2. Ninety percent of the co-op housing corporation’s expenditures are for acquiring, constructing, managing, maintaining, or caring for its property, for the benefit of its tenants-stockholders.

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<sup>1</sup> (From Library of Congress THOMAS)

- Allowing members of a qualified volunteer emergency response organization, i.e., an organization that provides firefighting and emergency medical services, to exclude state and local tax benefits, and certain payments for services from gross income.
  - Allowing certain full-time students who are single parents, and their children to live in housing units that are eligible for low-income housing credit if their children are not dependents of another individual.
  - Allowing a surviving spouse to exclude from gross income up to \$500,000 of the gain from the sale or exchange of a principal residence owned jointly with the deceased spouse. The sale or exchange must occur within two years of the death of the spouse, and other ownership and use requirements must be met.
  - Increasing the penalty for failure to file a partnership return, and extending the number of months in which such a penalty can be imposed from five months to 12 months. This provision also limits disclosure of tax return information that includes individual taxpayer identity information.
  - Imposing an additional penalty on S corporations for failure to file required tax returns.
  - Amending the Tax Increase Prevention and Reconciliation Act of 2005 to increase the estimated tax payment due in the third quarter of 2012 for corporations with assets of at least \$1 billion.
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## More real estate legislation

### Attempts to solve current problems, avert future losses

Senator Mike Machado also announced SB 1053 and SB 1054 on January 7 (Machado, Linden; Correa, Santa Ana). These two bills, along with SB 926 (Perata, East Bay) and Assembly Bill 69 (Lieu, Torrance) are aimed at remedying some of the questionable practices that contributed to the current real estate turmoil.

- **SB 1053** sets up reporting requirements for Department of Real Estate (DRE) licensees. Licensees who make, broker, or service mortgages must annually notify DRE of those activities. Also annually, real estate brokers in charge of mortgage brokering, lending, or servicing businesses must send DRE detailed compliance reviews of their books and records, and business activity reports that detail loans made during the prior year.
- **SB 1054** closes two loopholes in current law:
  1. The first provision of this law would give DRE the ability to ban individuals found guilty of violating the Real Estate Law from taking a real estate-related job with a company that has a different regulator.
  2. The second provision prohibits a real estate professional who gives an opinion of a property's value to a mortgage lender from acting as the listing agent on that property for a period of one year.

- **SB 926** (Perata, East Bay) would require face-to-face meetings between mortgage servicers and borrowers that are in default, to review the situation and talk about options. If passed, this bill would also require mortgage servicers to give at-risk homeowners several warnings before their adjustable rate mortgages were about to reset to higher interest rates. SB 926 would require lenders to notify borrowers three times that their mortgage interest rates were about to go up, and send notices to borrowers at four months, three months, and 45 days before the reset interest rate takes effect. It would also require lenders to give borrowers estimates of what their new payments would be under the increased interest rate.
- **Assembly Bill 69** (Lieu, Torrance) was amended to require lenders and related businesses regulated by the state to make monthly reports on the types of loans they are servicing or making. The monthly reports must include whether loans are past due, in foreclosure, or modified to avoid a loan default. State departments that regulate lenders and brokers would post this monthly report information on their public Websites.

This proposed legislation follows on the heels of earlier efforts by California's legislators and Governor Schwarzenegger to contain damage caused by mortgage foreclosures. In November 2007, the Governor announced an agreement with the loan servicers that constitute 25 percent of issued subprime mortgage loans (Countrywide, GMAC, Litton, and HomeEq) to freeze interest rates for certain affected homeowners.

### Impact on California

Recent statistics reported by RealtyTrac emphasize the depth of the mortgage default problem in California. Third-quarter foreclosure rates for 100 metropolitan areas across the nation reported in RealtyTrac's November 14, 2007 [press release](#) did not bode well for California. The list of the Top 10 metropolitan areas for foreclosures lists five in California. Stockton is in Rank 1, with one foreclosure filing for every 31 households. Also in the Top 10 are Riverside/San Bernardino (Rank 3), Sacramento (rank 6), Bakersfield (Rank 9) and Oakland (Rank 10). For the entire listing, visit RealtyTrac's [Website](#) at <http://www.realtytrac.com/home.asp>.

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### Correction to the 2007 *California Schedule CA (540)*

#### FTB printed version only

An error on a printed California tax form may lead some California taxpayers who file paper returns to understate their home mortgage interest deductions. The error is on early versions of Schedule CA (540), *California Adjustments*, which is used to make adjustments to federal adjusted gross income and federal itemized deductions.

On **Side 2, line 38**, there is an incorrect reference to **federal** Schedule A, *Itemized Deductions*. Line 38 of the *Schedule CA* incorrectly states: "Enter the total amount of itemized deductions from your federal form 1040, Schedule A, lines 4, 9, **13**, 19, 20, 27, and 28." It should have listed line number **15** instead of 13. This error could lead taxpayers to miss claiming their home mortgage interest, points, and investment interest.

In December, FTB mailed 1.1 million *California 540* and *540A* booklets to taxpayers, and another 1.3 million were sent to public distribution sites including libraries, post offices, and FTB field offices.

The instructions on page 56 of the *Resident Booklet* (540 and 54A) contain the correct line number reference.

All other versions of Schedule CA (540) are correct, including Package X, online forms, CalFile and e-file.

Taxpayers can use the form containing the error, and simply follow the instructions and include the figure from Schedule A line 15 rather than line 13.

Taxpayers who want a corrected form may download it from FTB's Website at [www.ftb.ca.gov](http://www.ftb.ca.gov), may request one by calling FTB at (800) 852-5711, or can wait until later this month when the corrected forms will be available at public distribution sites. Taxpayers may also use CalFile, or any of the approved electronic filing products listed on FTB's Website.

We encourage taxpayers who already have filed a paper tax return and followed the incorrect line numbers to call (800) 852-5711.

We updated our online forms, and notified tax software developers when the error was discovered in December. Tax booklets were already in the distribution process, however, and could not be recalled or corrected.

We expect slightly more than one percent of the 15 million personal income tax returns projected to be filed this year will be affected by the error.

Visit the FTB Website at [www.ftb.ca.gov](http://www.ftb.ca.gov) to find tax forms, answers to frequently asked questions, e-file, CalFile, and other information.

IRS *Schedule A - Itemized Deductions* and other federal tax information can be found on the IRS Website at [www.irs.gov](http://www.irs.gov).

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## Looking back – how we did in 2007 compared to 2006

Tax return processing in 2007 continued the steady climb in electronic processing we have witnessed in past years, for both personal income tax (PIT) returns and business entity (BE) returns.

### Returns filed

Of the 15.3 million returns filed in 2007, which is a 2.1 percent increase over total number filed in 2006, 9.5 million or 62.5 percent were received electronically. The previous year, 8.9 million, or 59.4 percent of PIT returns were received electronically.

The total number of business entity (BE) returns increased in 2007, to 1.38 million – a 15 percent increase over the preceding year. An even more dramatic increase in the number of e-filed BE returns occurred in 2007: 56,673 e-filed, compared to 10,544 in 2006. This represents a very impressive 437.5 percent increase in e-filed BE returns.

PIT Returns Received <sup>1</sup>	12/29/2007	12/29/2006	Change %
Total Paper	5,748,829	6,095,588	-5.7%
Total e-file	9,586,690	8,929,164	+7.4%
Total PIT Returns	15,335,519	15,024,752	+2.1%
<b>Paper Percentage</b>	<b>37.5%</b>	<b>40.6%</b>	<b>-7.6%</b>
<b>e-file Percentage</b>	<b>62.5%</b>	<b>59.4%</b>	<b>+5.2%</b>

BE Returns Received <sup>1</sup>	12/29/2007	12/29/2006	Change %
Total BE Paper	1,326,461	1,184,346	+12.0%
Total BE e-file	56,673	10,544	+437.5%
Total BE Returns	1,383,134	1,194,890	+15.8%
<b>BE e-file Percentage</b>	<b>4.1%</b>	<b>0.9%</b>	<b>+364.3%</b>

### Refunds issued

The number of direct deposit refunds (DDR), and the electronic processing of refunds also increased. Both PIT and BE DDRs increased in 2007 - by 10.7 percent and 38.1 percent, respectively. This increase was also reflected in the total dollar amount, and total number of refunds. Total dollar amount increased by 9.2 percent, and the total number of refunds issued in 2007 is 2.4 percent higher than 2006.

Refunds	12/29/2007		12/29/2006		Change %	
	#	\$	#	\$	#	\$
PIT	9,962,389	\$8,503,384,096	9,725,743	\$7,900,252,545	+2.4%	+7.6%
PIT DDR <sup>2</sup>	4,249,306	\$4,059,678,225	3,838,691	\$3,486,463,534	+10.7%	+16.4%
BE	138,332	\$1,674,325,606	137,495	\$1,421,311,132	+0.6%	+17.8%
BE DDR <sup>2</sup>	417	\$46,258,228	302	\$51,417,779	+38.1%	-10.0%
<b>Total Number of Refunds: PIT and BE</b>	<b>10,100,721</b>	<b>\$10,177,709,702</b>	<b>9,863,238</b>	<b>\$9,321,563,677</b>	<b>+2.4%</b>	<b>+9.2%</b>

### Payments deposited

The total number of deposits received in 2007 was up by 3.5 percent compared to 2006, and the total dollar amount increased by 0.4 percent. Making payments by paper continues to dominate

over electronic deposits, although the volume of electronic deposits is 8.9 percent higher than it was in 2006.

Deposits	12/29/2007		12/29/2006		Change %	
PIT, BE & NTD <sup>4</sup>	#	\$ <sup>1</sup>	#	\$ <sup>1</sup>	#	\$
Paper	10,529,479	\$29,497,394,071	10,236,310	\$30,102,030,239	+2.9%	+1.5%
Electronic <sup>3</sup>	1,422,807	\$10,087,732,841	1,306,911	\$10,392,998,097	+8.9%	-2.6%
<b>Total</b>	<b>11,952,286</b>	<b>\$40,668,503,924</b>	<b>11,543,221</b>	<b>\$40,495,028,337</b>	<b>+3.5%</b>	<b>+0.4%</b>
<b>Electronic %</b>	<b>11.9%</b>	<b>24.9%</b>	<b>11.3%</b>	<b>25.6%</b>	<b>+5.1%</b>	<b>-3.1%</b>

<sup>1</sup> Total rounded

<sup>2</sup> Direct Deposit Refunds are included in the Total

<sup>3</sup> Electronic payments include PIT and BE electronic payments, and PIT credit card payments.

<sup>4</sup> Non-tax debt comprises vehicle registration, court-ordered debt, and industrial health and safety cases referred to FTB for collection.

## Looking ahead - what's new in 2008?

### Registered Domestic Partners (RDP)

It hardly seems new, since we've been anticipating it since Fall 2006 – but the filing requirement takes effect this 2008 filing season. Effective for taxable years beginning on or after January 1, 2007, RDPs under California law must file their California income tax returns using either the married/RDP filing jointly or married/RDP filing separately filing status. RDPs will have the same legal benefits, protections, and responsibilities as married couples unless otherwise specified.

Taxpayers who entered into in a same sex legal union in another state, other than a marriage, and that union has been determined to be substantially equivalent to a California registered domestic partnership, effective for taxable years beginning on or after January 1, 2007, are required to file a California income tax return using either the married/RDP filing jointly, or married/RDP filing separately filing status. Information on what constitutes “substantially equivalent” is pending Attorney General's decision.

For more information on RDPs, see FTB Pub. 737, *Tax Information for Registered Domestic Partners*.

### Customer Service Number no longer required for Web pay

Now your clients can pay online using only their Social Security Number (SSN) and last name, provided their last name matches the last name we have on our records. Find out more about WebPay on our Website.

### Teacher Retention Credit

For taxable years beginning on or after January 1, 2007, the Teacher Retention Credit has been repealed.

## Round cents to dollars

Beginning with the 2007 tax forms, round cents to the nearest whole dollar. For example, round \$50.50 up to \$51 or round \$25.49 down to \$25. If you do not round, FTB will disregard the cents. This change helps process paper returns more quickly and accurately, and provides consistency with the electronically filed returns.

## Business entity return types that can be e-filed

Businesses are able to e-file the following return types and tax periods beginning on or after January 1, 2008.

Form	2007 Tax Year	2006 Tax Year	2005 Tax Year
100	X	X	X
100S	X	X	
565	X	X	
568	X	X	

Later in 2008, we will begin accepting e-filed Form 100W, *California Corporation Franchise or Income Tax Return - Water's-Edge Filers*, and Combined Returns, for taxable years beginning on or after January 1, 2008.

Preparers should check with their software providers to see if they support all types of Business e-file.

Business taxpayers can get more information on our Website at [www.ftb.ca.gov/professionals/efile/index.shtml](http://www.ftb.ca.gov/professionals/efile/index.shtml).

All forms and schedules that can be e-filed are listed in our [Business e-file Overview](#).

## Series LLC

Beginning January 2007, the LLC Fee will be based on total California source income rather than on worldwide total income. For further information, see the *LLC Income Worksheet Instructions* in the *California Forms and Instructions 568 Booklet*.

## Notes from the Tax Practitioner Stakeholder Specialist

### Filing season underway

That time of year is here! For many of you the crunch may not have started yet, but we at FTB have been working overtime to get ready for all those returns. A few things worth mentioning:

**Error on the Schedule CA printed form** - An error on a printed California tax form may lead some California taxpayers who file paper returns to understate their home mortgage interest deductions. The error is on early versions of Schedule CA (540), *California Adjustments*. This

should not be a problem for practitioners, since most file electronically, and FTB updated its online forms and notified tax software developers when the error was discovered in December.

**Mortgage Debt Forgiveness may be taxable in California** - California does not automatically conform to the "Mortgage Forgiveness Debt Relief Act of 2007" signed by the President on December 20, 2007. In order for the provisions of this act to apply to California, the legislature must enact conforming legislation. There is pending California legislation, Senate Bill 1055, which will provide modified conformity to provisions of this federal legislation. FTB will provide further information in the event this legislation is enacted. See the related article in this issue of *Tax News*, and check our Website at [www.ftb.ca.gov](http://www.ftb.ca.gov) under "law and legislation" for updates.

## Changes on the horizon

Beginning January 2008, Franchise Tax Board has a new Taxpayer Advocate, Steve Sims, EA. Steve has been with Franchise Tax Board for 25 years where he has worked as an auditor, collections supervisor, and most recently manager of the Department's Education and Outreach Section. Education and Outreach is Steve's passion and includes the tax practitioner liaison, small business liaisons, *Tax News* Publication, and the FTB Speakers' Bureau.

In his new role as the Advocate, Steve will try to identify developing trends relating to departmental problems by working with taxpayers and tax practitioner groups. He will also make recommendations for changes to departmental policies and practices to better enable taxpayers to meet their tax obligations. Finally, Steve will identify departmental policies and practices that create a burden for taxpayers and provide recommendations to reduce the burden. Steve will also continue to inform and educate practitioners by continuing as FTB's main public speaker. We wish Steve the best in his new role as Taxpayer Advocate!

*Editor's note:* Another change on the horizon is the temporary departure of FTB's Tax Practitioner Stakeholder Specialist, Susan Maples. Susan will be on maternity leave for the next several months. Susan will have a back up filling in for her while she's gone, so it should still seem like business as usual from your perspective. We will miss Susan, and wish her the best. We know she will enjoy spending time with her family, and the new little addition!

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## Inside FTB

### FTB tax refunds worth nearly \$10 million go unclaimed

You may have clients who are owed a California tax refund. More than 37,000 California taxpayers are owed \$9.8 million in state tax refunds that remain unclaimed, and we are trying to find them.

This year we issued nearly 10 million refunds worth more than \$8.4 billion. At issue are uncashed individual refunds ranging from a few dollars to more than \$68,000. In many cases, the U.S. Post Office returns the refund checks to FTB as undeliverable, often because taxpayers have moved between the times they filed their taxes and when the

refunds were mailed. Addresses for more than 5,000 unclaimed refunds worth more than \$2 million are listed as “invalid city,” “outside California,” and “redacted.”

FTB automatically reissues returned refunds once a new address is received. If you have clients that have changed addresses, encourage them to call us and update their address.

Your clients can check the status of their refund on our Website at [www.ftb.ca.gov](http://www.ftb.ca.gov). This feature is also available in Spanish.

They can also call (800) 852-5711, between the hours of 7 a.m. and 6 p.m., Monday through Friday, to check the status of their refund and update their address.

Encourage your clients to avoid delayed refunds by using direct deposit for a quick way to receive their state income tax refunds. In 2007, more than 4.2 million taxpayers had more than \$4 billion directly deposited into their bank accounts. This tops the previous year's 3.8 million total taxpayers who had \$3.4 billion in direct deposit refunds.

### **Attention nonresident entertainment withholding agents: Free workshops in February**

Learn how California withholding agents for **nonresident entertainers and speakers** are affected by 2008 procedure changes.

Attend a workshop to learn about the changes and how to comply.

#### **Workshop locations**

Los Angeles | Oakland | Sacramento | San Diego | San Francisco

All locations are architecturally accessible to persons with physical disabilities.

You can register online for workshops at these locations on our “Withholding – Nonresident Entertainers and Speakers” Webpage. You may want to bookmark this Webpage, which is dedicated to withholding for nonresident entertainers and speakers. You’ll find links to withholding procedure tools, news about withholding requirements for nonresident entertainers and speakers, announcements about workshops, and a link to the subscription service to receive email updates on nonresident withholding.

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### **Criminal Corner**

We are committed to closing California’s \$6.5 billion tax gap, defined as the difference between tax that is owed, and tax that is paid. Our special agents work cooperatively with law enforcement agencies throughout California to uncover illegal behaviors that contribute to the tax gap. These include underreporting income, overstating deductions, failing to file returns, failing to pay taxes due, and making illegal cash payments to employees.

Tax fraud is not a victimless crime. You can report suspected tax fraud by calling FTB at (800) 540-3453.

**Diamond Springs couple face state income tax evasion charges**

On January 10, 2008, a Diamond Springs couple surrendered to FTB special investigators, charged with four felony charges of state income tax evasion.

Emilio Rubalcaba, Jr., 73, and Dora Lee Velasquez, 57, operated two painting businesses, American Eagle Painting and Eagle Painting Company. According to investigators, Rubalcaba and his spouse, Velasquez, allegedly failed to file their 2001 - 2004 state income tax returns and failed to report the more than \$547,000 in taxable income they earned from the two painting companies.

The couple owes the state more than \$29,000 in unpaid tax. Interest, penalties, and the cost of the investigation will be added to this amount. Each count carries a maximum term of three years in state prison.

They provide painting services to local restaurants and work as subcontractors for other general contractors. Velasquez was sole owner of Eagle Painting Company, which she closed in 2003. Rubalcaba then opened his painting business, American Eagle Painting.

Rubalcaba and Velasquez were booked into the El Dorado County Jail, with bail set at \$15,000 each.

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